

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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| MidAmerican Energy Company | : | |
| | : | |
| Proposed general increase in gas rates. | : | 09-0312 |
| (Tariffs filed on June 2, 2009.) | : | |

February 19, 2010

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PROPOSED ORDER

By the Commission:

I. PROCEDURAL HISTORY

On June 2, 2009, MidAmerican Energy Company ("MEC", "MidAmerican", or "Company") filed new tariff sheets identified as Ill. C. C. No. 9 (the "Filed Rate Schedule Sheets"), by which it proposed a general increase in gas rates, effective July 20, 2009.

Notice of the filing was posted in public and conspicuous places in MidAmerican's commercial office in Moline, Illinois and published twice in newspapers of general circulation throughout MidAmerican's gas service area, in accordance with the requirements of Section 9-201(a) of the Public Utilities Act ("Act")¹ and the provisions of 83 Ill. Adm. Code 255.

After examining the Filed Rate Schedule Sheets, the Illinois Commerce Commission ("Commission") determined that they should not take effect until hearings were conducted concerning the propriety of the proposed general increase in gas rates embodied in those Filed Rate Schedule Sheets. On July 8, 2009, the Commission entered an Order suspending the Filed Rate Schedule Sheets to and including November 1, 2009. On October 7, 2009, the Commission re-suspended the Filed Rate Schedule Sheets to and including May 1, 2010.

By letter dated June 30, 2009, the Administrative Law Judge ("ALJ") notified MEC of certain deficiencies in its filing in accordance with 83 Ill. Adm. Code 285, Standard Filing Requirements for Electric, Gas, Telephone, Water and Sewer Utilities in Filing for an Increase in Rates. The deficiency letter required MidAmerican to provide various revised and additional schedules or an explanation as to why certain schedules need not be provided. MidAmerican provided information responsive to the deficiency letter. There are no outstanding deficiencies and MidAmerican has complied with all other Standard Filing Requirements for gas utilities.

¹ 220 ILCS 5/9-201(a).

A Petition to Intervene was filed by the Citizens Utility Board ("CUB") on August 3, 2009, and was granted.

Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter came on for hearing before the ALJ at the Commission's offices in Chicago, Illinois on July 21, 2009 and December 2, 2009. Appearances were entered by counsel on behalf of MidAmerican, the Staff of the Commission ("Staff") and CUB.

At the December 2, 2009 hearing, one witness on behalf of MidAmerican, and two witnesses on behalf of Staff, presented testimony and exhibits. The parties stipulated into evidence the remaining pre-filed testimony and exhibits. The record in this case consists of the transcript, pre-filed written testimony and other exhibits. The record contains a detailed analysis of MidAmerican's operations, including MidAmerican's operating revenues and expenses, the original cost and accumulated depreciation of the Company's property, and the cost of capital and other matters relating to the appropriate rate of return and revenue requirement for MidAmerican.

On January 25, 2010, the ALJ marked the record "Heard and Taken."

MidAmerican and Staff each filed an Initial Brief ("IB") on December 28, 2009 and a Reply Brief ("RB") on January 7, 2010.

MidAmerican and Staff filed a joint draft order on January 14, 2009.

II. NATURE OF MIDAMERICAN'S OPERATIONS

MidAmerican, a subsidiary of MidAmerican Energy Holdings Company, is an electric and gas distribution utility serving customers in Illinois, Iowa, South Dakota and Nebraska. During calendar year 2009, MEC served 25 Illinois communities, including Moline, East Moline, and Rock Island, and approximately 65,700 customers, with about 128 million therms of natural gas sold and 41 million therms delivered to gas transportation customers. MEC owns approximately 2,352 miles of gas distribution main and piping.

III. SUMMARY OF MIDAMERICAN'S PROPOSAL

In its direct testimony and exhibits, MidAmerican indicated that its Filed Rate Schedule Sheets would increase annual jurisdictional gas revenues by a total of \$3,387,000 or an average increase of 3.6 percent over test period *pro forma* gas revenues for 2008.

MidAmerican's last adjustment to its base natural gas distribution rates occurred in 2002² with a \$2,227,000 increase in rates. MEC was granted a gas rate increase of

² MidAmerican Energy Company, Proposed General Increase in Gas Rates, Docket No. 01-0696, Order, September 11, 2002.

3.40% on September 11, 2002 which was designed to produce a return on common equity of 11.20% and a return on original cost gas rate base of 8.85%.

Dean A. Crist, Vice President of Regulation, described the principal components of MEC's current rate filing. He testified that, since the time of filing its last natural gas rate case, MEC's costs have increased as a result of increased operating costs including the costs of materials and supplies, labor and employee benefits. During this time, MEC says it has continued to construct normal gas distribution facility additions.

IV. TEST YEAR AND PROPOSED REVENUE INCREASE

For this proceeding, MidAmerican selected an historic test year consisting of the 2008 calendar year with pro forma adjustments. No party objected to the test year selected by MidAmerican. The Commission finds MEC's proposed test year reasonable for purposes of establishing Illinois jurisdiction gas rates in this docket.

It is MEC's position that the test year total operating revenue is \$21,445,000. The test year operating income statement proposed by MEC reflects the Company's revised proposed rate increase of \$2,998,000 and a rate of return on rate base of 8.011%. This reflects modifications to MEC's original filed position and also that MEC accepted certain adjustments proposed by Staff³.

Staff asserts that MEC's total operating revenue is \$21,154,000 and a rate of return on rate base of 7.54%. The rate of return on rate base is the only remaining disputed issue impacting the revenue requirement.

V. RATE BASE

A. UNCONTESTED ADJUSTMENTS TO MIDAMERICAN'S PROPOSAL

Initially, MidAmerican proposed an Illinois jurisdictional original cost rate base, including certain appropriate adjustments, associated with the provision of gas service of \$37,383,576⁴. Staff proposed several adjustments to rate base, as described below, that were accepted by MEC for purposes of this proceeding. After accepting these proposed adjustments, MidAmerican's proposed Illinois jurisdictional original cost rate base is \$37,146,000⁵. These adjustments, which the Commission finds appropriate, are discussed below. .

1. Utility Plant in Service – Des Moines LP Plant

An adjustment was made to remove the utility plant, related accumulated depreciation, and accumulated deferred income taxes for the Des Moines LP plant. The

³ MEC Ex. RRT 3.1, Revised Schedule A-2.

⁴ MEC Ex. MJA 1.0 at 2, line 34, MEC Ex. RRT 1.2, Schedule B-1.

⁵ MEC Ex. RRT 3.1, Revised Schedule A-2, and Staff Ex. 8.0, Schedule 8.1, at 1 of 2, line 23.

related depreciation expenses are discussed further in the operating income section below⁶.

Staff also recommended that the gain on the sale be amortized over five years to allow a “normalized” level of gain on the sale of the plant to be considered in the revenue requirement⁷. While the Company did not oppose the removal of the Des Moines LP plant from rate base, MidAmerican did oppose the accounting treatment for the gain on the sale of the Des Moines LP plant⁸.

MidAmerican contended that the proper accounting treatment is “below the line,” because charges to ratepayers for the use of the assets dedicated to utility service are based on the original cost of the assets. MEC argued that, given its agreement to remove the original cost of the assets from rate base, customers are no longer paying for the original cost of the Des Moines LP plant in base rates⁹. Consequently, MidAmerican customers bear no risk of over-compensating the Company by the amount of the rate of return associated with the assets sold.

Staff stated that the Company accepted all of Staff’s proposed accounting adjustments, except for the adjustment to amortize the gain on the sale. Staff noted that this issue was the only accounting-related contested issue, and that the cost of litigating the issue could potentially increase rate case expense to the extent that such increased costs could offset the annual amortization of the gain on the plant sale. Therefore, Staff withdrew its proposed adjustment¹⁰.

2. Cash Working Capital

Cash Working Capital (CWC) is the amount of funds required from investors to finance the day-to-day operations of the Company. The term “lag days” refers to the time period between the rendering of a service and the payment by the customer. “Lead days” refers to the time period between the incurrence of an expense and the payment by the Company. The net day lag is the difference between revenue lag days and expense lead days. In its direct filing, MidAmerican developed a CWC amount of \$1,082,000, calculated based on the net lag methodology. With this approach, for each expense classification, the net day lag for that expense classification is multiplied by the daily expense for that expense classification to produce the CWC requirement for that expense classification. The individual expense classifications are then summed to yield the total CWC requirement.

In its direct filing, Staff calculated its CWC requirement of \$234,000 based on a gross lag methodology. With this approach, the CWC requirement is developed by first calculating the revenue lag CWC requirement, then calculating the expense lead CWC

⁶ Staff Ex. 1.0 at 9; Staff Ex. 3.0 at 7-10.

⁷ Staff Ex. 1.0 at 9.

⁸ MEC Ex. MJA 2.0 at 2 and 4.

⁹ MEC Ex. MJA 2.0 at 4.

¹⁰ Staff Ex. 8.0 at 6.

requirement for each expense classification, and then summing these amounts to yield the total CWC requirement. Staff favors its approach because it accounts for the relative weights of revenues and expenses rather than simply the difference in days for receipt or payment.

In an effort to narrow the contested issues in this case, MidAmerican, in its rebuttal filing, accepted Staff's proposed adjustments to CWC, subject to two modifications.

In its rebuttal filing, Staff incorporated the modifications suggested by MidAmerican and calculated a CWC requirement of \$361,000.

3. Materials and Supplies

The amount of rate base was reduced by the amount of accounts payable associated with materials and supplies inventory. Staff noted that the Company's proposed 13-month average of materials and supplies was not reduced by the associated accounts payable, and the Company's shareholders do not incur any cost of financing when materials and supplies were purchased on account with a vendor until the account is paid. An account payable represents "vendor financing" of purchased merchandise until it has been paid in full. Since the vendor is in effect financing these purchases until paid, the Company's shareholders have no investment in the related materials and supplies inventory. The materials and supplies inventory should be reduced by the amount of accounts payable related to such inventory because the Company should not earn a return on investment (purchased inventory) until it has been funded by the Company's shareholders¹¹.

4. Pension Liability

Staff presented an adjustment to add the accrued liability of the MEC pension plan costs to the Company's total accumulated liability for pensions. Staff noted the accrued liability should represent the aggregate MEC pension plan costs recognized in the income statement which have not been paid to a third party. However, the Company's rate base reduction did not include the balance for the MEC Accrued Pension Liability¹².

The Company agreed and proposed an adjustment to the accumulated provision for pension component¹³. The adjustment includes the pension liability, but removes the supplemental executive retirement plan ("SERP") plan and deferred compensation liabilities from MidAmerican's rate base calculation. In making the adjustment, the Company noted its filing requirements incorrectly included liabilities for the SERP and

¹¹ Staff Ex. 1.0 at 10-11.

¹² Staff Ex. 1.0 at 11.

¹³ MEC Ex. MJA 2.0 Schedule 2.4, Schedule B-16.

deferred compensation plans and incorrectly excluded the liability for the qualified pension plan in the calculation of the rate base adjustment for accrued pension costs¹⁴.

The Company noted that the purpose of the accumulated provision for pension component of rate base is to reduce rate base for benefits accrued through income that have not yet been funded¹⁵. The Company's adjustment included the qualified pension plan, which meets this criterion in that over the course of several years, costs have been accrued as expenses pursuant to Accounting Standards Codification 715 (formerly FAS 87) that were not required to be, and had not yet been, funded to the pension trust at December 31, 2008. Such customer-provided funds are normally treated as a reduction of rate base.

The SERP and deferred compensation plans are non-qualified plans, meaning that they do not meet certain regulatory criteria laid out by the Employee Retirement Income Security Act of 1974 ("ERISA"). For financial reporting purposes under generally accepted accounting principles, the full amount of the SERP and deferred compensation liabilities must be reported even though funds have been set aside to settle the liability through future benefit payments¹⁶. This accounting treatment (a "rabbi trust") contrasts with that used for qualified plans where payments into the external trust reduce the accrued liability. The use of rabbi trusts to set aside assets is common for these types of plans and has been in place for years at MidAmerican and its predecessor companies.

MidAmerican has no discretion to use such funds other than for the purpose of paying SERP and deferred compensation benefits. Therefore, consistent with Staff's testimony, no reduction to rate base is necessary for these liabilities.

5. Adjustment for Automated Meter Reading Project

MidAmerican proposed a revision to its adjustment for its Automated Meter Reading (AMR) project to reflect known and measurable additions to rate base resulting from the acceleration of the project completion from year end 2010 to year end 2009¹⁷. MidAmerican calculated the pro forma adjustment by using actual capital expenditures for the first nine months of 2009 and then adding forecasted capital expenditures through the end of the year. The Company also included the total anticipated cost savings resulting from the completion of the project¹⁸. Staff did not object to the adjustment¹⁹.

B. APPROVED RATE BASE

¹⁴ MEC Ex. RTT 2.0 at 5.

¹⁵ *Id.*

¹⁶ *Id.* at 6.

¹⁷ MEC Ex. MJA 2.0 at 3.

¹⁸ *Id.*

¹⁹ Staff Ex.8.0 at 5.

Taking into consideration Staff's proposed adjustments to which MEC did not object, the Commission concludes that MEC's Illinois jurisdictional gas rate base for the 2008 test year with pro forma adjustments is \$37,146,000, as shown in Appendix A hereto. The table below depicts the components of the approved rate base.

| | <u>000s</u> |
|---|------------------------|
| Gross Plant In Service | \$118,595 |
| Accumulated Depreciation and Amortization | <u>(64,170)</u> |
| Net Utility Plant in Service | 54,425 |
| Additions to Rate Base | |
| Cash Working Capital | 361 |
| Deductions from Rate Base | |
| Materials and Supplies | (159) |
| Customer Advances for Construction | (939) |
| Customer Deposits | (44) |
| Accumulated Provisions for Pensions | (3,305) |
| Budget Plan Balances | (534) |
| Accumulated Deferred Income Taxes | <u>(12,659)</u> |
| Rate Base | <u><u>\$37,146</u></u> |

Finally, Staff requested that the Commission include the following provision in this Order:

It is further ordered that the \$117,982,708 original cost of plant for MidAmerican at December 31, 2008, as reflected on the Company's Schedule B-4, Page 2 of 2, line 51, Column(e) is unconditionally approved as the original cost of plant²⁰.

MEC did not object and the Commission finds the substance of Staff's recommendation reasonable.

VI. REVENUE REQUIREMENT

A. MIDAMERICAN'S PROPOSAL

In its direct testimony, MidAmerican indicated that for the 2008 historical test year, its Illinois jurisdictional gas tariffed revenues were \$17,423,000. Originally, MEC

²⁰ Staff Ex. 1.0 at 12.

proposed to increase rates and revenues by \$3,387,000; after accepting certain adjustments to its proposal recommended by Staff, MEC is now proposing a rate increase of \$2,998,000. MEC's operating income statement at proposed rates is summarized as follows:

| | 2008 Pro Forma at Proposed Rates 000s |
|--|---|
| Revenues: | |
| Tariffed Revenues | \$20,421 |
| Other Revenues | <u>1,024</u> |
| Total Operating Revenues | <u>21,445</u> |
| Operating Expenses: | |
| Uncollectible Accounts | 462 |
| Other Gas Supply | 242 |
| Other Storage | 221 |
| Distribution | 6,461 |
| Customer Accounts | 1,813 |
| Customer Service and Sales | 757 |
| Administrative and General | 1,769 |
| Depreciation and Amortization | 3,275 |
| Taxes Other Than Income | <u>2,057</u> |
| Total Operating Expenses Before Income Taxes | 17,057 |
| Federal Income Tax | 3,854 |
| State Income Tax | 931 |
| Deferred Income Taxes | (3,355) |
| Investment Tax Credits | (18) |
| Total Operating Expenses | <u>18,469</u> |
| Pro Forma Net Operating Income | <u><u>2,976</u></u> |

B. UNCONTESTED ADJUSTMENTS TO MEC'S PROPOSAL

Staff proposed numerous adjustments to the Company's operating income statement, which MEC did not contest for purposes of this proceeding. These

adjustments are identified below. The Commission finds these adjustments to be appropriate.

1. PGA Revenues and Costs

Staff recommended that the purchased gas adjustment (PGA) revenues and costs be removed from the 2008 test year. Staff noted that PGA revenues and costs pertain to the cost of gas purchased by MEC for distribution to gas customers and the revenues derived from recovery of those costs. The purpose of the instant proceeding is to establish rates for gas delivery service²¹. Staff, therefore, argued the inclusion of the cost of gas and corresponding recovery of those costs as revenues would distort the revenue requirement that forms the basis for setting the new delivery service rates.

2. Executive Perquisites

The amount of executive perquisites included in the 2008 test year operating expenses was removed. Staff noted that executive perquisites include the value of executive life insurance premiums paid by the Company, separate from regular broad-based life insurance benefits, reimbursements for financial counseling costs and taxes paid by employees related to personal use of Company aircraft, as well as reimbursement of applicable payroll taxes on supplemental retirement plan benefits accrued. Staff argued that the expenses are not only discretionary, but also unnecessary for the provision of utility service and recommended the removal of these costs from operating income²².

3. Pro Forma Retirement Plan Costs

The impact of the Company's pro forma increase to test year operating expense for retirement plan costs was removed from operating expenses because the increase is not known and measurable²³.

4. Energy Efficiency Revenue and Costs

Energy Efficiency Revenues and Costs were excluded from the revenue requirement since these costs are recovered under a separate rider, outside of base rates²⁴.

5. Des Moines LP Operating Statement Impact

Consistent with the adjustments to rate base noted above, the impact of depreciation and operation and maintenance expenses for the Des Moines LP facility was removed from the 2008 test year revenue requirement²⁵.

²¹ Staff Ex. 2.0 at 3.

²² Staff Ex. 2.0 at 4-5.

²³ Staff Ex. 2.0 at 5.

²⁴ Staff Ex. 2.0 at 7.

6. Call Center and Customer Accounts Savings

Two adjustments were made to reduce the customer accounts and customer service expenses, resulting from savings experienced from staff reductions in the call center and in the number of billing representatives in early 2009. The savings are a result of the AMR project²⁶. The adjustment also reflects savings in customer accounts expenses due to efficiencies also gained from the AMR project. These adjustments reflect known and measurable changes.

7. Sale of Wholesale Gas

Staff, in direct testimony, proposed an adjustment to remove from the revenue requirement revenues and costs related to the unregulated sales of wholesale gas. The Company did not object in principle, but noted that Staff's adjustment did not consider additional revenue resulting from sales at wholesale to MidAmerican's unregulated retail services group for resale to its unregulated end-use customers. The Company pointed out that when these revenues are taken into account, in addition to the revenues and costs contained in Staff's adjustment, the result is a total net impact on operating income of zero. Staff agreed with the Company's presentation of the adjustment²⁷.

8. Automated Meter Reading Depreciation Adjustment

As a result of spending during 2009 on the AMR project, greater than that which was reflected in its test year, rate base has been increased. This increased rate base necessitates an increase in depreciation expense²⁸. Staff did not oppose the Company's adjustment²⁹. Staff and the Company agreed to also correct the income tax impact due to the AMR depreciation reflected in the Company's Revised Schedule C-2B.3 – AMR Depreciation pro forma adjustment³⁰.

VII. COST OF CAPITAL AND RATE OF RETURN

Four witnesses submitted testimony regarding the cost of capital of MEC's gas operations. James M. Behrens presented the Company's analysis of its capital structure and weighted average cost of capital ("WACC"). Kathleen C. McShane presented the Company's cost of common equity analysis. Sheena Kight-Garlich presented Staff's analysis of the Company's capital structure and WACC. Janis Freely presented Staff's analysis of the cost of common equity.

²⁵ Staff Ex. 2.0 at 8, Staff Ex. 3.0 at 8 and 10.

²⁶ Staff Ex. 2.0 at 8-9.

²⁷ Staff Ex. 2.0 at 1.0; Staff Ex. 9.0 at 2-3; MEC Ex. RTT 2.0 at 3 & MEC Ex. RRT 2.6, Revised Schedule C-2B.2.

²⁸ MEC RTT 2.0 at 4.

²⁹ Staff Ex. 8.0 at 5.

³⁰ Staff Ex. 8.0 at 5-6.

MidAmerican proposed a rate of return on rate base of 8.011% based upon a capital structure consisting of 1.60% short-term debt at a cost of 1.59%, 50.82% long term debt at a cost of 5.48%, 0.50% preferred stock at a cost of 4.63%, and 47.08% common equity at a cost of 11.00%³¹.

Staff proposed a rate of return on rate base of 7.54% based upon a capital structure consisting of 1.96% short-term debt at a cost of 1.59%, 50.63% long term debt at a cost of 5.48%, 0.50% preferred stock at a cost of 4.63%, and 46.91% common equity at a cost of 10.05%³².

A. SHORT-TERM DEBT BALANCE

For purposes of this proceeding, Staff accepted MEC's proposed balance of short-term debt in the capital structure. However, Staff stated it did not agree with MEC's methodology used to calculate the balance of short-term debt. Staff stated the Commission should accept MEC's balance of short-term debt without ruling on the merits of MEC's methodology.

The Commission finds MEC's balance of short-term debt reasonable in this proceeding. The Commission's acceptance of MEC's balance of short-term debt should not be considered an endorsement of MEC's methodology used to calculate that balance.

B. COST OF COMMON EQUITY

The only element of MEC's cost of capital that remains in dispute in this proceeding is the cost of common equity. The Company and Staff essentially agree that the cost of common equity is the rate of return, or compensation, that investors require in order to purchase a firm's stock and thereby provide money for its operations³³. They disagree, however, about the proper methodology for determining that rate of return and, accordingly, the amount of that return. Based on the application of its preferred methods, MEC proposes an 11% return on common equity³⁴. Staff's methods yield a recommendation of 10.05%³⁵.

Because MEC's Illinois gas operations are not a stand-alone entity, equity in those operations cannot be separately purchased on an exchange or in some other manner. Consequently, the cost of equity for those operations is determined by establishing a proxy, quantifying a cost of equity for that proxy, and making any adjustments ascribable to meaningful distinctions between MEC's gas operations and financial characteristics and the proxy's. MEC constructed its proxy by identifying nine

³¹ MEC Ex. JMB 2.1, Sch. 1.

³² Staff Ex. 12.0, Sch. 12.1.

³³ MEC IB at 9; Staff IB at 2.

³⁴ MEC Ex. KCM 2.0 at 17.

³⁵ Staff Ex. 6.0 at 2.

local gas distribution companies (the “Gas Sample”) and appropriately averaging certain characteristics of those companies. The construction of the proxy is not in dispute.

Using that proxy, both parties employ standard models for determining the cost of common equity. Specifically, they each use the discounted cash flow (“DCF”) model and the capital asset pricing model (“CAPM”), although they differ with respect to certain inputs for, or variations of, those models. The Commission has found the DCF and CAPM models sufficient for quantification of the cost of equity in previous dockets.

Staff identifies the following five disputed issues: (1) whether it is appropriate to utilize the results of the constant growth DCF model (along with the results of the non-constant growth model) ; (2) the appropriate estimate of long-term growth to use in the third stage of the non-constant growth DCF model; (3) the appropriate risk-free rate to use in the CAPM; (4) whether to use Staff’s beta estimates derived from monthly data (along with both parties’ use of betas derived from weekly data); and (5) the appropriate financial risk adjustment to recognize the different levels of financial risk for MEC and the Gas Sample. The Commission will address these in turn.

There are also differences regarding the use of historical data and regarding the relevance of current economic conditions when determining investor-required return on common equity. However, neither the impact of those differences on the five issues enumerated above, nor the question of whether these differences are themselves disputed issues, is clearly delineated by the parties. Additionally, MEC utilizes the comparable earnings test to confirm the results of its other models. Staff rejects the comparable earnings test. But again, it is not clear that the parties expect a formal resolution of their disagreement. The Commission will address the foregoing disputes only insofar as that is necessary for decision-making in this docket.

1. DCF – Use of Constant Growth

In the ratemaking context, the objective of the discounted cash flow (“DCF”) model is to estimate the investor-required return on a common stock that is projected to grow at a given rate, or sequence of rates, over the long term. The model presumes that the price of a share of stock reflects the present value of its future expected cash flows, discounted at a rate that reflects the investor’s required return on that particular investment. Using the known stock price and expected cash flow stream per share, DCF permits a calculation of the investor’s required return.

MEC, through Ms. McShane, relied on two versions of the DCF model – the constant growth model and the non-constant growth model. Staff, through Ms. Freetley, relied only on the non-constant growth model. The question, then, is whether better results would be derived in this instance from the non-constant growth model alone.

Staff explains that the constant growth model uses a single growth rate, “which is presumed to be sustainable indefinitely.”³⁶ As such, its accuracy is dependent upon the

³⁶ Staff Ex. 6.0 at 5.

congruence of the short-term forecasted growth rate and projected long-term growth rate of the entity studied³⁷. The long-term growth rate is presumed to approximate long-term overall economic growth. In this instance, the average short-term (3-5 year) growth rate for the Gas Sample is 6.33%, while the current growth expectation for the U.S. economy (as measured by Gross Domestic Product) is about 4.7%³⁸. Staff asserts that “no company could sustain into infinity a growth rate any greater than that of the overall economy.”³⁹ Moreover, Staff maintains, utilities generally have below-average growth rates.⁴⁰ Therefore, Staff concludes, the extant near-term growth prediction for the Gas Sample (the proxy for MEC’s Illinois gas operations), is “not sustainable,” rendering the constant growth DCF model inappropriate here⁴¹.

As a general proposition, MEC avers that two DCF models are better than one. An averaging of the two DCF models “recognizes the imprecision of the period during which investors might expect analysts’ forecast growth rates to persist and avoids results that are potentially internally inconsistent.”⁴² Furthermore, MEC argues, Staff’s rejection of the constant growth model for DCF purposes contradicts both Staff’s use of constant growth elsewhere in this case (in Staff’s risk premium modeling) and Staff’s use of that model in its DCF analysis in MEC’s last rate case in 2002⁴³. In fact, the Company emphasizes, the difference between short-term and long-term estimated growth rates was larger in the 2002 rate case, yet Staff still employed the constant growth DCF model⁴⁴.

The Commission finds that Staff’s rejection of the constant-growth model in this instance is warranted. MEC attempts to address the mismatch between short-term and long-term growth expectations⁴⁵ by retaining the constant growth model that suffers from that mismatch, but averaging it with the non-constant growth model. Staff has the better solution. When prevailing circumstances undermine the efficacy of a model, the Commission would rather set that model aside (all things being equal) than try to mask its deficiency with an average⁴⁶.

Regarding Staff’s work in MEC’s 2002 rate case, we agree with Staff that it would be unwise to preclude Staff from “modify[ing] its methodology even when a revised methodology more accurately reflects existing circumstances, and is likely to yield more reliable results.”⁴⁷ As for the use of constant growth in Staff’s equity risk premium

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² MEC Ex. KCM 3.0 at 4.

⁴³ MEC Ex. KCM 2.0 at 6.

⁴⁴ *Id.*

⁴⁵ MEC witness McShane does not disagree with Staff’s witness that current growth forecasts for the Gas Sample utilities are unsustainable in the long run. MEC Ex. 3.0 at 3.

⁴⁶ The Commission notes that we similarly rejected use of the constant growth DCF model in Illinois-American Water Company, Proposed General Increase in Water and Sewer Rates, Dckt. 07-0507, Order, July 30, 2008, at 92, because the growth rates posited there were unsustainable over time.

⁴⁷ Staff RB at 3.

modeling, Staff explains that performing a non-constant growth analysis on the S&P 500 would have strained its resources⁴⁸. Unquestionably, applying the non-constant growth model to hundreds of corporations is a much more extensive task than applying it to the nine utilities in the Gas Sample⁴⁹. Indeed, neither party employed non-constant growth in its risk premium modeling. Moreover, Staff maintains that some of the projected short-term growth rates for S&P 500 companies are no more sustainable than the parallel forecasts for the Gas Sample⁵⁰. Assuming that is correct, then the inclusion of constant growth in the parties' risk premium computations created upward bias, overstating the cost of equity, as Staff suggests⁵¹. If anything, we should question both parties' calculation of market risk premium in their CAPM analysis (below), rather than approving constant growth for DCF purposes in this case.

2. DCF – Long-Term Growth

This disputed issue concerns one of the inputs used in the non-constant growth DCF model. Both parties look at anticipated growth over three discrete time intervals (hence the name “non-constant” growth) - from year one through year five (the first stage), from year six through year ten (second stage), and for the ten years thereafter (third stage). Both parties agree that the appropriate growth rate for the third stage is the long-run, overall economic growth rate for the economy as a whole. But they disagree about the appropriate source for the forecast of that growth rate⁵².

MEC witness McShane bases her third-stage growth rate on the consensus of economists' forecasts found in Blue Chip *Financial Forecasts* (June 2009). The consensus expected long-run (2011-2020) nominal rate of growth in the economy (GDP) is 5.1%⁵³. For her third-stage growth rate, Ms. Freetly calculated an implied 20-year Treasury bond yield of 4.83%, derived from actual current 10- and 30-year U.S. Treasury bond rates⁵⁴.

Ms. McShane opined that, while the two approaches should be similar “in theory,” the long-term government bond yield “may deviate from its long-term equilibrium level due to such factors as monetary policy, the current point in the business cycle, and the effects of flight to quality, as occurred during the recent credit crisis.”⁵⁵ She showed that, based on changes in the implied forward yield on the 20-year Treasury rate, long-term economic growth expectations “declined by over 2 percentage points between August 2007 and December 2008 and then rose by 1.7 percentage points between December 2008 and the end of September 2009...[O]ver

⁴⁸ Staff Ex. 13.0 at 5.

⁴⁹ To be precise, after eliminating companies without dividends or growth projections, 356 firms remained in Ms. Freetly's analysis. Staff Ex. 6.0 at 17.

⁵⁰ Staff Ex. 13.0 at 5.

⁵¹ *Id.*

⁵² Each witness uses her third-stage growth rate as an input for computing her second-stage growth rate, which is an average of the rates in her first and third stages. MEC Ex. 1.0 at 29; Staff Ex. 6.0 at 7.

⁵³ MEC Ex. KCM 1.2, Updated Schedule 6.

⁵⁴ Staff Ex. 6.0 at 7.

⁵⁵ MEC Ex. KCM 2.0 at 3.

the same period of time, the consensus forecasts of long-term economic growth...have been virtually unchanged.”⁵⁶ MEC therefore concludes that economists’ “direct estimate of long-term economic growth,” based on “the mean of a large sample of economic forecasts” to reduce bias, is the superior input for the third stage of the non-constant DCF model here⁵⁷.

Staff responds that the Blue Chip forecast used by Ms. McShane only projects forward ten years (starting in 2011), which “do[es] not even overlap, much less coincide with, the period of time the [third growth] stage covers.”⁵⁸ Further, Staff argues, the recent swings in the implied 20-year forward Treasury yield cited by Ms. McShane demonstrate that investor’s “current long-term expectations vary over time.”⁵⁹ Consequently, the implied Treasury yield more aptly captures “changing investor expectations due to current economic conditions” than the economists’ forecasts Ms. McShane relies upon, which were “essentially static.”⁶⁰ Furthermore, Staff contends, those forecasts “might not be updated very often,” citing three examples of annual or semi-annual revisions.⁶¹ “Hence, the alleged stability in the Blue Chip forecasts of long-term economic growth might come from a low update frequency.”⁶² Staff also claims that its implied 20-year growth rate is “supported by Global Insight’s forecast of 4.5% nominal GDP growth for the 2019-2039 period.”⁶³

As noted, each side adopts the premise that in the final stage of their three-stage growth model (the perpetual stage that commences after the tenth year), the Gas Sample will grow at the rate of the overall economy. Each also uses company-specific estimates for the first five years of their model. And both use projected overall economic growth rates that include those same five years, plus the following five years, to estimate third-stage growth. Specifically, MEC uses analysts’ overall growth estimates for the first through the tenth years, while Staff uses, in part, the current 10-year Treasury rate. But Staff also employs the current 30-year Treasury rate, in order to produce an implied 20-year Treasury rate that would begin after the tenth year out.

The difference, then, is that MEC’s methodology does not include any component pertaining to the time period when the third stage actually begins (after the tenth year). In contrast, Staff’s methodology attempts to predict the economic circumstances that will prevail at the start of the tenth year. In effect, MEC assumes that analysts’ present estimate of overall growth rate in year one (5.1%) is the appropriate growth rate for the ensuing 20 years (and, theoretically, into perpetuity).

⁵⁶ *Id.* at 4.

⁵⁷ MEC IB at 23.

⁵⁸ Staff IB at 19-20.

⁵⁹ *Id.* at 20.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ Staff RB at 5. Staff’s 20-year projection is “supported by” Global Insight’s forecast insofar as the latter is even lower than Staff’s 4.83% implied 20-year estimate. However, the two estimates are 33 basis points apart, while Staff and MEC are 27 basis points apart (4.83 % vs. 5.1%). By that measure, Staff and MEC more closely “support” each other.

Staff assumes that the present Treasury rate for year one is the appropriate overall growth rate for 10 years, then re-calibrates growth for the third stage of its model. Of course, Staff's projection is based entirely on current information and expertise, but MEC's blunter approach is, too. Since the Commission perceives no basis for according greater credibility to either the commercial analysts that developed the 10-year GDP estimate or the Treasury analysts that developed the 10-year and 30-year bond rates, and since the parties do not disagree that the two sources will theoretically produce similar results⁶⁴, the Commission will rely on Staff's more nuanced analysis.

3. CAPM – Risk-Free Rate

The premise of the Capital Asset Pricing Model ("CAPM") is that "an investor requires compensation for non-diversifiable risk only."⁶⁵ Conversely, the investor does not expect compensation for diversifiable risk, which can be eliminated by investing in a portfolio of securities whose individual and diverse risks balance each other out.⁶⁶ Thus, the CAPM focuses on the general risks that cannot be diversified away with an appropriately diverse portfolio, such as the risk of interest rate changes or economic growth that varies from expectations.⁶⁷ These systematic factors affect all securities.

Accordingly, there are three components in the CAPM: the risk free rate (the rate the investor can get without bearing any appreciable risk); the expected market risk premium (the investor's reward for accepting non-diversifiable risk); and the beta of the pertinent investment (to account for the difference between general market risk and the specific risk of that investment). Here, the Commission addresses the parties' dispute regarding the appropriate source of the risk free rate for CAPM purposes. (Their disagreement with respect to the appropriate beta is addressed in the next subsection of this Order).

MEC, through Ms. McShane, uses forecasted yields on the 30-year Treasury bond as the proxy for the risk-free rate in the CAPM. According to 2009 forecasts, the expected average yield for the 30-year bond over the period from 2010 to 2014 is 5.2%.⁶⁸ Ms. McShane advises against using a short-term rate, which she characterizes as "administered" for purposes of monetary policy, rather than "market-driven."⁶⁹ While noting that she has previously used the projected yield on the 10-year Treasury bond in her CAPM analysis, she asserts here that the 30-year bond "more closely matches [the] perpetual life of equities."⁷⁰

For Staff, Ms. Freetly also selects the 30-year Treasury bond rate. However, unlike Ms. McShane, she does not employ a forecasted yield for some future time.

⁶⁴ As the preceding footnote indicates, this theoretical proposition is supported by the actual results produced here.

⁶⁵ MEC Ex. KCM 1.0 at 34.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ MEC Ex. KCM 2.0 at 12.

⁶⁹ MEC Ex. KCM 1.0 at 35.

⁷⁰ *Id.*

Rather, she chooses the effective 30-year bond yield published on August 18, 2009 (4.4%).⁷¹ Ms. Freetly notes that the long-term bond is not entirely risk-free, “due to the inclusion of an interest rate risk premium associated with its relatively long term to maturity.”⁷² Nonetheless, she asserts that it “more closely approximates the long-term, risk-free rate” than did the then-current (on August 18, 2009) short-term Treasury bill⁷³.

The difference between the two approaches - which both use the 30-year bond yield to represent the risk free rate - is that MEC employs a forecasted rate and Staff refers a single day’s actual rate. Staff’s position is that the current rate⁷⁴ on the date selected encompasses “all relevant, currently available information, including investor expectations regarding future interest rates.”⁷⁵ Thus, Staff contends, the forecasts MEC relies on are captured in the long-term bond yield offered on Ms. Freetly’s chosen date⁷⁶. MEC counters that a single-day “spot” yield on the 30-year Treasury bond is unreliable when present economic conditions are temporarily suppressing that yield. “Consequently, for purposes of determining a forward-looking cost of equity that will be reflected in going forward rates, the risk-free rate should incorporate the rise in interest rates that is widely expected to occur.”⁷⁷

MEC is correct that the rates approved by this Order will be applied on a going-forward basis. The period of time during which those rates will apply is, however, unknown⁷⁸. Accordingly, the Commission, which cannot establish a cost of equity that fluctuates with investor expectations over time, must approve a single cost of common equity that will function effectively for an indefinite number of years. If MEC is correct that Staff’s selected spot yield is anomalously low, because of transient circumstances that are already trending up toward normalcy, the Company will be disadvantaged in the capital markets in the foreseeable future. Conversely, if Staff is correct that the actual August 18, 2009 yield reasonably reflects the return that knowledgeable investors expect over the next 30 years, customers are likely to overpay for MEC’s capital costs if the Company’s risk-free rate is utilized.

The Commission concludes that Staff’s spot yield is too low to serve as the risk-free rate for CAPM purposes in this instance. Staff itself recognizes that real GDP growth “is a proxy for the real risk-free rate.”⁷⁹ Ms. Freetly relies on sources predicting average annual real GDP growth of 2.6% (over 10 years) to 2.7% (over 30 years), which “imply a long-term, nominal risk-free rate between 4.3% and 5.2%.”⁸⁰ She thus

⁷¹ Staff Ex. 6.0 at 14-16.

⁷² *Id.* at 16.

⁷³ *Id.* Treasury bills “are issued with terms to maturity ranging from four weeks to six months.” *Id.* at 13.

⁷⁴ Under the Act, our ratemaking process can take up to 11 months. Consequently, the “current” rate is typically not the prevailing rate on the date of our Order, but the rate on the day within the ratemaking process that testimony was prepared.

⁷⁵ Staff IB at 26-27.

⁷⁶ *Id.* at 27.

⁷⁷ MEC RB at 8.

⁷⁸ MEC’s rates were last revised in 2002. By comparison, Peoples Gas sought revisions in 2007 and again in 2009.

⁷⁹ Staff Ex. 6.0 at 15.

⁸⁰ *Id.* at 15-16.

accepts the conceptual efficacy of forecasts and demonstrates that her chosen 4.4% rate is at the low end of the particular forecasts she cites. Moreover, those forecasts are consistent with the range of 30-year bond yield forecasts (4.8%-5.2%) that MEC presents⁸¹. Therefore, the Commission will select a yield of 4.8% for the CAPM risk-free rate here. That is slightly above the mid-point of Staff's acknowledged range of forecasted GDP growth and within the range of MEC's forecasted long-term bond yields.

4. CAPM – Beta

As stated above, the CAPM also requires selection of an appropriate beta, to represent the difference between general market risk and the specific risk of an investment (in this case, the composite Gas Sample that serves as the proxy for MEC's Illinois gas operations). The beta reveals how much a stock price fluctuates when the entire stock market (or an index) fluctuates, thus quantifying the divergence of their respective movements (and risk)⁸². Utilities typically demonstrate less volatility (hence, less risk) than an entire market or market-wide index. That is reflected in the parties' recommended betas here - .61 by Staff and .66 by MEC⁸³.

The methodological dispute between the parties is straightforward. Ms. McShane, the Company's witness, derived her Gas Sample betas from Value Line. They are based on weekly data, involving 260 data points⁸⁴. Staff's witness, Ms. Freetly, also used the Value Line betas, but not exclusively. She additionally used Zack's betas and performed her own regression analysis on the Gas Sample⁸⁵. In the latter instances, the betas emerged from monthly data, involving 60 data points⁸⁶. To balance the monthly and weekly data in her analysis, Ms. Freetly first averaged the monthly Zack's and regression betas, then averaged the result with the weekly Value Line betas⁸⁷. The issue for the Commission, therefore, is whether to approve (for CAPM purposes) betas based solely on weekly data or betas produced by a blend of weekly and monthly data.

In support of weekly data alone, MEC emphasizes the greater number of tabulated data points, which the Company maintains will "diminish the impact of outlying observations, and improv[e] the explanatory power of the analysis."⁸⁸ To confirm this, Ms. McShane calculated betas for the five-year periods ending in each year from 2005 through 2009, using both weekly and monthly data⁸⁹. She states that the results demonstrate the lower standard error and greater predictive reliability of weekly

⁸¹ MEC Ex. KCM 2.0 at 11-12.

⁸² Generally, and in this case, betas are developed from data over a five-year period.

⁸³ The farther the beta is below 1, the lower its volatility/risk.

⁸⁴ MEC Ex. KCM 2.0 at 8.

⁸⁵ Staff Ex. 6.0 at 17.

⁸⁶ *Id.* at 19.

⁸⁷ *Id.* at 21.

⁸⁸ MEC IB at 30.

⁸⁹ MEC Ex. KCM 2.0 at 9-10.

observations⁹⁰. Ms. McShane also emphasizes that Staff's regression betas have consistently been lower than Value Line betas in other Commission rate proceedings⁹¹. Further, she avers, "the actual returns of gas distributors have been higher, on average, over time than the Value Line betas would have predicted."⁹²

Staff recommends utilizing blended weekly and monthly data because "they have strengths and weaknesses relative to each other."⁹³ While the lower standard error renders weekly beta estimates "usually more reliable," monthly betas "are less susceptible to non-synchronous trading"⁹⁴ and exhibit lower volatility (because the samples are fewer and farther apart)⁹⁵. With respect to non-synchronous trading, Ms. Freetly conducted an analysis using weekly betas that showed a statistically meaningful lag by the Gas Sample securities, relative to the overall market.⁹⁶ In contrast, monthly betas did not lag in a statistically meaningful degree⁹⁷. Ms. Freetly also spins around Ms. McShane's observation that Staff's regression betas are lower than Value Line betas, positing that the latter may simply be too high⁹⁸.

MEC rejoins that non-synchronous trading is a relevant phenomenon "when analyzing daily data collected on thinly traded stocks."⁹⁹ But gas utilities are not thinly traded¹⁰⁰. Moreover, Ms. McShane says, the lagging returns Ms. Freetly associates with weekly betas "may relate to the market conditions during the financial crisis rather than to non-synchronous trading issues."¹⁰¹ She also asserts that Ms. Freetly "downplays" the importance of the standard error, which is the principal determinant of statistical reliability¹⁰².

Very recently, in rate proceedings concerning Peoples Gas and North Shore Gas, Staff proposed the same beta selection, calculation and weighting that it does here, and the Commission expressly approved that approach (adopting a beta estimate of .59)¹⁰³. In 2001, as Staff notes in its IB at 21, the Commission held that neither Value Line's weekly betas nor Staff's regressions based on monthly betas were the superior choice - and we adopted the latter¹⁰⁴. Between 2001 and our recent Order for Peoples

⁹⁰ *Id.* at 9.

⁹¹ *Id.* at 8.

⁹² MEC Ex. KCM 3.0 at 11.

⁹³ Staff Ex. 13.0 at 13.

⁹⁴ "Non-synchronous trading" occurs when information generally affecting stock prices is not reflected in a particular stock. That stock is lagging or not "in synch" with the market. Staff Ex. 13 at 8; MEC Ex. KCM 3.0 at 8.

⁹⁵ *Id.*

⁹⁶ *Id.* at 8.

⁹⁷ *Id.* at 8-9.

⁹⁸ *Id.* at 6, fn. 5.

⁹⁹ MEC Ex. 3.0 at 8.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 9.

¹⁰² *Id.* at 9-10.

¹⁰³ North Shore Gas Co. /The Peoples Gas Light & Coke Co., Proposed General Increase in Natural Gas Rates, Dckt's. 09-0166 & 09-0167 (consol.), Order, 2010, at 126-27.

¹⁰⁴ Illinois-American Water Co., Proposed General Increase in Water Rates, Dckt. 00-0340, Order, Feb. 15, 2001 at 25.

Gas and North Shore Gas, we have relied on Staff's beta estimates, derived from monthly data, in several proceedings¹⁰⁵.

To proceed differently here, without acting arbitrarily, the Commission would have to conclude that monthly betas are so dramatically inferior to weekly betas that they ought to be abandoned altogether (rather than averaged with weekly data). The record and briefings in this proceeding do not persuade us to do that. Indeed, the Commission agrees with Staff that the two methodologies have strengths and shortcomings that are constructively balanced by averaging. Accordingly, Staff's estimated beta of .61 should be utilized in the CAPM for the purpose of determining MEC's cost of common equity in this docket.

5. Financial Risk Adjustment

A company's cost of equity is a function of both its business (or operating) risk and its financial risk. Business risk concerns the likelihood of achieving the monetary (cash flow) objectives of the enterprise. Financial risk is associated with the firm's financial characteristics. MEC and Staff agree that the Company has more financial risk than the proxy group of gas utilities. Both proposed an upward adjustment to the return on equity obtained from their models (to account for that higher financial risk). They disagree, however, regarding the proper mechanism for quantifying the magnitude of the adjustment - and, consequently, they arrive at different proposed adjustments.

The relevant principle here is that a firm's cost of equity increases as the proportion of equity in its capital structure decreases, because debt is paid before equity holders are rewarded. Therefore, the more debt in the firm's capital structure, the greater the claim of debt-holders on cash flow. Put differently, the equity shareholder's financial risk (of insufficient funds for dividends) is heightened as debt takes up more of the capital structure.

In this instance, MEC emphasizes (and Staff does not disagree) that its book value capital structure has less equity (47.75%) - and therefore more risk - than does the Gas Sample composite market value capital structure (about 60%). The Company proposes to account for that difference by increasing its return on equity in an amount commensurate with the greater risk MEC's book value capital structure presents. Ms. McShane provides the computations, based on market data and certain assumptions¹⁰⁶. The result is an additional 80 basis points in allowed return on equity¹⁰⁷. She stresses that this represents what an *equity* investor (as contrasted with a bond investor) would demand in the market¹⁰⁸.

¹⁰⁵ E.g., Aqua Illinois, Inc.: Tariffs Seeking General Increase in Water Rates for the Kankakee Water Division, Dckt. 03-0403, Order, April 13, 2004, at 42; Central Illinois Light Co.: Proposed General Increase in Natural Gas Rates, Dckt. 02-0837, Order, Oct. 17, 2003, at 37-38.

¹⁰⁶ MEC Ex. KCM 1.0 at 52-55.

¹⁰⁷ MEC Ex. KCM 2.0 at 25.

¹⁰⁸ *Id.* at 20.

In contrast, Staff proposes to account for the greater risk in MEC's book value capital structure by essentially equalizing the implied credit ratings of the Company's Illinois gas operations and the Gas Sample. Specifically, Ms. Freetly recognized that Staff's revenue requirement recommendations would produce an implied credit rating of Baa2 (per Moody's debt rating formula for gas utilities), meaningfully below the implied credit rating of A3 for the proxy sample. She identified the difference in long-term debt costs associated with that credit rating differential and (again using Moody's formula) calculated an upward adjustment of 42 basis points in allowed return on equity¹⁰⁹.

MEC and Staff each justify their respective approach - and criticize each other's - at considerable length. For the most part, the arguments are familiar and, as the Company forthrightly acknowledges, the Commission has consistently favored Staff's analysis¹¹⁰. Indeed, utility regulatory commissions typically do precisely what the Company decries. That is, as the Company itself candidly states, "[r]egulatory convention applies the allowed equity return to a book value capital structure."¹¹¹ Thus, MEC is asking us to both abandon our own prior practice and veer away from our regulatory peers¹¹². While our previous decisions are not binding precedent, we cannot depart from them arbitrarily, particularly when they are in harmony with regulatory custom. Moreover, application of a market-based rate of return to a book value capital structure has not impeded utility financing. "If that process provided a return that did not meet investor requirements, market prices would fall towards book value. Yet, the market prices of utility stocks continue to exceed book value."¹¹³

Given the utilities' success in maintaining market values in excess of book values, the Company's proposed adjustment is a solution in search of a problem. Moreover, while MEC resists the characterization of its proposal as a market-to-book adjustment¹¹⁴, that proposal is nevertheless designed to, in effect, equalize the Company's book value capital structure and the market value capital structure of the Gas Sample composite. We do not regard that as an appropriate mechanism for quantifying the greater financial risk of MEC's book value capital structure, which is the relevant capital structure for ratemaking purposes. In contrast, Staff accepts the Company's book value capital structure as a given and attempts to identify a viable proxy for the greater risk associated with that capital structure. Unlike MEC's purported proxy, Staff's is rooted in book value financial ratios, thus keeping our focus on

¹⁰⁹ Staff Ex. 6.0 at 28.

¹¹⁰ *E.g.*, Ameren CILCO / CIPS / IP, Proposed General Rate Increase for Delivery Services, Dckt's. 06-0070/06-0071/06-0072 (consol.), Order, November 21, 2006, at 142-43; Ameren CIPS/Ameren UE, Proposed General Rate Increase in Natural Gas Rates, Dckt's. 02-0793/03-0008/03-0089 (consol.), Order, October 22, 2006, at 87.

¹¹¹ MEC IB at 43.

¹¹² MEC notes that the Pennsylvania Public Utility Commission (PPUC) has already approved financial risk adjustments to compensate for the application of market-derived cost of equity to a book value capital structure. MEC Ex. KCM 1.0 at 55-56, citing PPUC v. PPL Electric Utilities Corp., Dckt. R-000492555 (2007).

¹¹³ Staff Ex. 6.0 at 38.

¹¹⁴ MEC Ex. KCM 3.0 at 13.

investment devoted exclusively to regulated gas utility operations¹¹⁵. While there may be other viable proxies, the bond ratings at the core of Staff's methodology are certainly a valid reflection of risk. As MEC states, "[t]he bond rating the company receives from the major credit rating agencies is a means of objectively comparing the risks that the company faces."¹¹⁶

6. Comparable Earnings Test

MEC presents the results of its comparable earnings test "as an indicator of whether the market-based cost of equity test results are reasonable."¹¹⁷ According to the Company, the comparable earnings test shows that competitive firms of similar investment risk to the proxy group are able to earn returns of 15.0-16.0% on book value¹¹⁸. Therefore, MEC contends that its recommended return on equity for its Illinois natural gas utility operations (11%) "is conservative when compared to the earnings level of relatively low risk unregulated companies."¹¹⁹

Staff responds that the comparable earnings methodology does not measure investor-required return on equity¹²⁰. Therefore, Staff avers, "the returns being earned by unregulated companies do not provide a relevant perspective on the reasonableness of the recommended return on equity."¹²¹ Staff catalogues a long line of cases, dating back over 20 years, in which the Commission has rejected the comparable earnings test¹²².

The Commission understands that MEC offered the comparable earnings test to validate the reasonableness of the results of its other models, rather than to quantify return on common equity. Nevertheless, since we concur with Staff that the test is not apposite to the determination of ROE, it is not suitable as a validation of that return either. Given our consistent dismissal of the comparable earnings test in this context, our rejection here will come as no surprise to the Company.

7. Use of Historic Data

Staff criticizes the use of what it describes as the use of historic data in the Company's DCF and risk premium analyses. It is not completely clear to the Commission whether Staff seeks a separate ruling on the general value of historic data

¹¹⁵ In Bluefield Water Works & Improvement Co. v. Public Service Comm'n of the State of West Virginia, 262 U.S. 679 (1923), a seminal case cited by MEC, the US Supreme Court stated that a public utility "is entitled to such rates as will permit it to earn a return *on the value of the property which it employs for the convenience of the public.*" 262 U.S. at 692 (emphasis added). The value of the property MEC employs for public convenience is expressed as book value.

¹¹⁶ MEC IB at 38.

¹¹⁷ MEC IB at 37.

¹¹⁸ MEC Ex. KCM 1.0 at 62.

¹¹⁹ MEC IB at 37.

¹²⁰ Staff Ex. 13.0 at 17.

¹²¹ *Id.*

¹²² Staff Ex. 6.0 at 42.

in cost of equity determinations or whether it is focusing on specific deficiencies in MEC's DCF and risk premium results. We will consider Staff's argument in the latter context.

With respect to the Company's DCF modeling, MEC correctly observes that the parties' disparate approaches have yielded essentially identical results¹²³. The Company's 30-day dividend yield from the late summer in 2009 and Staff's preferred one-day yield from August 2009 are virtually the same (an average yield of 4.24% and 4.41% for MEC, and 4.24% and 4.42% for Staff)¹²⁴. Consequently, MEC stresses, the parties' different approaches "have no impact one way or the other" on the results of their DCF analyses¹²⁵. The Commission agrees.

Regarding the inputs to MEC's risk premium modeling, the Commission is unsure of what Staff wants. Staff does not identify a discrete dispute concerning the parties' calculated market risk premiums in the list of contested issues in its IB at 2-3 (enumerated above). Therefore, the purpose of its generic complaint about historic data may be simply to generally undermine MEC's risk premium analyses. Alternatively, Staff may want us to reject MEC's specific risk premium calculations, in the same manner that Staff sought rejection of MEC's risk-free rate and beta. But the latter subjects were explicitly framed as contested issues. In the absence of a clearly delineated issue for resolution, the Commission will take no action here. We note MEC's admonition that "[Staff witness] Freetly herself incorporates historical data in her CAPM analysis as historical data are used to calculate the beta."¹²⁶ Thus, the Commission cannot discern either a general or specific issue for resolution concerning historical data.

8. Current Market Conditions

MEC disapproves of Staff's purported failure to "provide any testimony or evidence regarding current market conditions," which the Company alternately describes as "uncertain" and "a deep recession that is expected to last for an extended period of time."¹²⁷ MEC thus expresses one of the abiding contradictions underpinning the parties' presentations of their respective cases. The Company predicts long-lasting deep recession, but defends, for DCF modeling, short-term gas utility forecasts that exceed traditional returns. Staff complains that historic data is inferior to current information, but rejects the use of those same *current* short-term forecasts for DCF modeling. There are other incongruities in this proceeding. That said, as we indicated in the preceding sub-section of this Order with regard to historic data, there is no specific issue framed regarding the significance of current conditions. Accordingly, the Commission will not render a ruling (indeed, we do not know what ruling there could be

¹²³ MEC RB at 4-5.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ MEC Ex. KCM 2.0 at 18.

¹²⁷ MEC IB at 14.

on the present record). We do believe, however, that current conditions are reflected in an appropriate manner in the parties' modeling.

9. Commission Conclusion

Based on our resolution of the disputed issues above, and based on Staff's methodology and inputs, the Commission concludes that MEC's allowed return on equity should be set at 10.13%.

C. APPROVED RATE OF RETURN ON RATE BASE

In view of our findings regarding capital structure and the costs of various capital components, the Commission concludes that MEC should be authorized an 7.60% rate of return on rate base. Consistent with this conclusion, the following table shows how the rate of return on rate base for ratemaking purposes is calculated:

MEC's Weighted-Average Cost of Capital

December 31, 2008

| <u>Capital Component</u> | <u>Balance</u> | <u>Ratio</u> | <u>Cost</u> | <u>Weighted-Average Cost</u> |
|--------------------------|-----------------|--------------|-------------|------------------------------|
| Long-Term Debt | \$2,690,741,247 | 50.82% | 5.476% | 2.78% |
| Short-Term Debt | \$84,456,894 | 1.60% | 1.587% | 0.03% |
| Preferred Equity | \$26,714,494 | 0.50% | 4.628% | 0.02% |
| Common Equity | \$2,492,999,643 | 47.08% | 10.13% | 4.77% |
| Total | \$5,294,912,278 | 100.00% | | 7.60% |

VIII. COST OF SERVICE

MEC witness Melanie Acord prepared a cost-of-service (“COS”) study, included as Section 285.5110, Schedule E-6. MEC utilized new customer classifications of Small Volume, Medium Volume, and Large Volume for COS purposes. Historically, MEC utilized Rate 60 - Residence Gas Service, Rate 70 - General Service, Rate 80 - Contract Service, Rate 87 - Off-Peak General Service, and Rate 85 - Large General Service customer classifications¹²⁸. Staff witness William Johnson had no objections to the Company’s proposed move to Small Volume, Medium Volume, and Large Volume customer classifications¹²⁹.

Mr. Johnson proposed an adjustment to the Company’s proposed COS study whereby the Weighted Customers - Customer Service class allocation factor would be developed using throughput rather than margin as proposed by the Company¹³⁰. Staff pointed out that the Commission ruled in Docket No. 01-0696 that marketing costs in the Weighted Customers - Customer Service class allocation factor should be developed using Commission Staff’s proposed throughput allocator rather than MEC’s proposed margin allocator.

MEC accepted Staff’s proposed Weighted Customers – Customer Service class allocation factor based upon throughput rather than margin¹³¹.

The Commission finds the COS, with Staff’s proposed adjustment, reasonable.

IX. WEATHER NORMALIZATION

MidAmerican proposed a weather normalization adjustment designed to determine a level of sales and revenues under existing rates that could be reasonably expected given current climate conditions, thus eliminating the effect on test year sales and revenues of having either an unusually cold or an unusually warm winter¹³². MidAmerican proposed to represent current climate conditions based on a “hinge-fit” statistical regression model defining normal weather heating degree days (HDDs). MidAmerican noted the model is recognized by the National Oceanic and Atmospheric Administration (“NOAA”) and is supported by public research conducted by NOAA, the University of Maryland, and the University Corporation for Atmospheric Research. The model is further described in MidAmerican’s direct testimony and in research published in the November 2007 Journal of Applied Meteorology and Climatology¹³³. MEC’s application of the hinge-fit model analyzes historical heating degree days for MidAmerican’s Illinois service territory going back to 1951.

¹²⁸ Staff Ex. 7.0 at 9-10.

¹²⁹ *Id.* at 12.

¹³⁰ *Id.* at 13.

¹³¹ MEC Ex. MAA 2.0 at 2.

¹³² MEC Ex. CBR 1.0 at 2.

¹³³ MEC Ex. CBR 1.0 at 5; MEC Ex. CBR 1.5.

Staff did not object to MidAmerican's use of the hinge-fit model to determine normal HDDs or the use of the resulting 5,895 HDDs as the basis for normal weather in the calculation of the weather normalization pro forma adjustment in this docket. Mr. Johnson stated that in response to a Staff Data Request, MEC provided actual Moline HDD for 1981-2008. The average of the actual Moline HDD's for twelve years (1997-2008) is 5,904, the average for eleven years (1998-2008) is 5,854, and the average for ten years (1999-2008) is 5,913. Mr. Johnson further stated that MEC's proposed Normal HDD of 5,895 appears reasonable when compared to the average of the actual HDD's over the ten-, eleven-, and twelve-year periods¹³⁴.

The Commission finds the Company's weather normalization adjustment reasonable.

X. RATE DESIGN

A. METER CLASSES

MEC proposed meter charges that are divided into four meter classes based on the size and capacity of the meters. The classes are:

Class 1 – Meters up to 675 cubic feet per hour capacity at seven inches water column;

Class 2 – Meter capacities over 675 cubic feet per hour, up to 3,000 cubic feet per hour at seven inches water column;

Class 3 – Meter capacities over 3,000 cubic feet per hour, up to 11,000 cubic feet per hour at seven inches water column;

Class 4 – Meter sizes over 11,000 cubic feet per hour at seven inches water column.¹³⁵

MEC proposed to include a separate line item on the customer's bill that would be identified as "Meter Charge."¹³⁶

Mr. Johnson stated that he had no objection to the Company's proposal to have four separate meter class charges based on the size and capacity of the meters. Staff opined that there are currently Commission-regulated gas utilities that utilize some form of rated meter capacity in the determination of their fixed customer charges. Mr. Johnson further stated that some Commission-regulated electric utilities currently have separate meter charges that are based upon voltage levels. Mr. Johnson agreed with the Company that the meter size required by a customer is dependent upon the connected load the customer may require and it is apparent from the Company's

¹³⁴ Staff Ex. 7.0 at 8.

¹³⁵ MEC Ex. MAA 1.0 at 19.

¹³⁶ Staff Ex. 7.0 at 15.

Section 285.5110, WPE-6.1, that as meter size and capacity increases, so does the cost of the meter¹³⁷.

However, Mr. Johnson testified that there are customers who may currently have Class 2, 3, or 4 type meters on their premises and because of cost considerations may not want them any longer. Whether it is possible to change the meter because of load considerations will, in Mr. Johnson's opinion, ultimately be up to the Company. If a customer can operate with the use of a smaller meter, that customer should be entitled to lower rates as soon as possible. Thus, Mr. Johnson recommended that the Commission order the Company to resolve all customer complaints regarding meter-related issues and respond to all requests for meter changes before the customer's next billing cycle.¹³⁸

Ms. Acord stated that she was concerned with Staff's proposed next-billing-cycle time-frame both initially and on an on-going basis. MEC stated that it will be proactive in its efforts to educate and inform its customers of the changes prior to implementing the proposed rate design, but many customers may not understand the impact of the change until their bill actually arrives with the new charges.¹³⁹ Ms. Acord further stated that there are approximately 1,500 meters in Meter Classes 2 through 4 that have the potential for meter inquiries.¹⁴⁰ Ms. Acord's concern was that if all 1,500 inquiries were received in the first month of implementing the new meter charge rate design, investigation of and resolution for all inquiries within a single billing cycle would be highly unlikely.¹⁴¹ For example, Ms. Acord stated that a meter inquiry received on the fifth day of the billing cycle could be more easily investigated and resolved than an inquiry received on the 29th day of a bill cycle. The ability to complete all steps of an investigation by the next bill cycle rests on when the customer makes the request during the bill cycle.¹⁴²

Ms. Acord suggested that a six-month transition period be implemented. The Company stated that when a meter size/capacity inquiry is received, an investigation would be conducted to establish the customer's metering needs and determine whether the meter size/capacity could be reduced. If the investigation indicates the meter size could be changed to one that results in a different meter class, the customer's next meter charge would be changed to reflect the revised meter size. Upon expiration of the first six-month period, MidAmerican would commit to initiation of a meter investigation within the current billing cycle, with resolution completed within 30 days¹⁴³.

However, since MEC has stated that it could not investigate 1,500 inquiries in one billing cycle or in 30 days, Ms. Acord stated that it would prioritize the meter inquiries to focus on those customers with a higher likelihood of changing meter size

¹³⁷ Staff Ex. 7.0 at 18.

¹³⁸ Staff Ex. 7.0 at 19.

¹³⁹ MEC Ex. MAA 2.0 at 3.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* at 5.

¹⁴³ MEC Ex. MAA 2.0 at 3.

that could result in a change in meter class¹⁴⁴. MEC would begin with the meters at the lower end of each meter class spectrum. For example, MEC stated that meter Class 2 includes those meters over 675 cubic feet per hour and up to 3,000 cubic feet per hour; a meter Class 2 customer with a size 1,000 cubic feet per hour meter has a higher likelihood of an investigation yielding the ability to reduce the meter size to a Class 1 than a customer with a Class 2 meter size of 3,000 cubic feet per hour¹⁴⁵.

For meter inquiries received during the six-month transition period which cannot be investigated and resolved within 30 days, MidAmerican would refund the difference in meter class charges should it be determined, through the investigation, that the customer's meter class could be reduced. If the meter is changed and a refund is due, MidAmerican would provide a credit to the customer based on the difference in meter class charges during the bill cycle after receipt of the inquiry. Subsequent to the transition period, if meter class charges are revised, they would be revised on the next bill cycle with no refund for prior billing periods¹⁴⁶. MEC witness Acord also stated that MidAmerican would not consider changing a customer's meter class on the customer's bill upon receiving an inquiry until such time that the meter investigation can be completed¹⁴⁷.

Mr. Johnson stated that he did not object to MEC's suggestions related to resolving meter related issues. Mr. Johnson stated that the intent of his recommendation to resolve all customer complaints regarding meter-related issues and respond to all requests for meter changes before the customer's next billing cycle was to give customers an opportunity to evaluate their meter options and then act on them if possible. Staff witness Johnson believes the Company's proposed plan for resolving meter-related issues meets his suggested goals¹⁴⁸.

The Commission finds the proposed meter classes and inquiry resolution process reasonable.

B. RATE CLASSES

MidAmerican proposed a new rate design that included three major service classifications: Small, Medium, and Large Volume services. MEC stated that Small Volume service includes residential and small commercial customers. A separate rate designation for residential customers is to be maintained, but the pricing for the service will be the same as the non-residential rate¹⁴⁹. MEC's proposed Small Volume Service includes a monthly basic service charge, a per-therm distribution charge, and a monthly meter charge¹⁵⁰. MEC proposed that Small Volume transportation customers have the

¹⁴⁴ MEC Ex. MAA 2.0 at 4.

¹⁴⁵ *Id.*

¹⁴⁶ MEC Ex. MAA 2.0 at 4.

¹⁴⁷ *Id.* at 5.

¹⁴⁸ Staff Ex. 14.0 at 5.

¹⁴⁹ MEC Ex. MAA 1.0 at 17.

¹⁵⁰ *Id.* at 21.

same type of charges as sales customers; however the amount of the distribution charge would be different and there would be administrative charges applicable¹⁵¹.

MEC's proposed Medium Volume Service includes a monthly basic service charge, a per-therm distribution charge, and a monthly meter charge¹⁵². MEC proposed that Medium Volume transportation service also include a monthly basic service charge, a per-therm distribution charge, and a monthly meter charge; however the amount of the distribution charge would be different and there would be administrative charges applicable¹⁵³.

MEC's proposed Large Volume Service includes a monthly basic service charge, a per-therm distribution charge, a monthly meter charge, a distribution demand charge per therm of contract maximum daily requirement ("MDR"), and a distribution demand charge per therm of contract maximum hourly quantity ("MHQ") which is a newly proposed charge¹⁵⁴. MEC proposed that Large Volume transportation service also include a monthly basic service charge, a per-therm distribution charge, a monthly meter charge, a MDR charge, and a MHQ charge; however the amount of the distribution charge would be different and there would be administrative charges applicable¹⁵⁵.

Staff did not object to the Company's proposed rate design for the Small, Medium, and Large Volume Gas service classes¹⁵⁶.

The Commission finds the proposed rate design for the proposed classes reasonable.

C. BILL IMPACTS

MEC stated that it performed several analyses to determine the rate impacts on its customers. MEC found that the average bill for the Small Volume class would increase an estimated \$4 per month. The average bill for the Medium Volume class would decrease an estimated \$63 per month and the average bill for the Large Volume class would decrease an estimated \$800 per month¹⁵⁷. The Company also provided bill comparisons in Section 285.5135, Schedule E-9, that are not actual bill impact summaries since they do not show usage by month for a typical customer. The Company's bill comparisons give an indication of what monthly increases or decreases are possible at various therm usage levels.

¹⁵¹ *Id.* at 21 & 23-24.

¹⁵² MEC Ex. MAA 1.0 at 21-22.

¹⁵³ *Id.* at 22-24.

¹⁵⁴ MEC Ex. MAA 1.0 at 22.

¹⁵⁵ *Id.*

¹⁵⁶ Staff Ex. 7.0 at 20-25.

¹⁵⁷ MEC Ex. MAA 1.0 at 23.

After reviewing MEC's responses to data requests Mr. Johnson stated that he did not have concerns about the percent increases identified in the Company's bill comparisons. Referring to MEC's proposed new meter charges that are divided into four meter classes, Mr. Johnson opined that customers who have larger meters have gas needs that require larger meters. Customers should pay for the larger meters, and typically customers with larger meters use more gas¹⁵⁸.

1. Rate RV – Small Volume Service

Based upon the company's responses to certain data requests, Mr. Johnson determined that an average customer who is currently a Rate 60 customer and would be moving to Rate RV Meter Class 1 under the Company's proposal would see an overall annual rate increase of 5.17%¹⁵⁹. Staff requested that the Company identify the average bill increase for Residential Rate 60 customers who are placed in either Meter Class 2, 3, or 4. The Company responded that a current Residential Rate 60 customer with a Class 2 meter (69 associated customers) would see an average monthly increase of 10.9%; a Residential Rate 60 customer with a Class 3 meter (7 associated customers) would see an average monthly increase of 9.9%; and a Residential Rate 60 customer with a Class 4 meter (2 associated customers) would see an average monthly increase of 23.5%¹⁶⁰.

Mr. Johnson explained that customers who are served under Meter Classes 2, 3, and 4 will use greater quantities of gas than a typical residential customer. In response to a Staff Data Request the Company provided a schedule showing present rates and proposed rates, and monthly bills for the twelve months of the test year at the present and proposed rates for an average customer for Rate 60 that is moving to Rate RV. The annual therm usage for an average residential customer in Meter Class 1 is 977 therms, Meter Class 2 is 4,570 therms, Meter Class 3 is 14,563 therms, and Meter Class 4 is 6,833 therms. Residential customers who are currently paying a basic service charge of \$10.50 a month, and have a larger meter than a typical residential customer (for example they are placed in Meter Class 2 under the Company's proposed rates), will have a basic service charge of \$13.10 and a meter charge of \$32.17 a month. The larger fixed costs drive up the monthly percent increase when there is low therm usage. As therm usage increases the fixed costs comprise a smaller proportion of the customer's total bill and the total monthly percent increase becomes less¹⁶¹.

2. Rate SV – Small Volume Service

In response to a Staff Data Request the Company provided a spreadsheet showing present rates and proposed rates, and monthly bills for the twelve months of the test year at the present and proposed rates for an average customer for Rate 70 moving to Rate SV. The total annual percentage change for a Rate 70 sales customer

¹⁵⁸ Staff Ex. 7.0 at 37.

¹⁵⁹ Staff Ex. 7.0 at 32.

¹⁶⁰ *Id.* at 33.

¹⁶¹ *Id.* at 33-34.

moving to Rate SV sales would be negative (3.95)% for Meter Class 1, 1.04% for Meter Class 2, 0.18% for Meter Class 3, and 0.76% for Meter Class 4. The total annual percentage change for a Rate 70 transportation customer moving to Rate SV transportation would be negative (14.40)% for Meter Class 1, negative (22.36)% for Meter Class 2, negative (14.19)% for Meter Class 3, and 9.43% for Meter Class 4¹⁶².

3. Rate MV – Medium Volume Service

In response to a Staff data request, the Company stated that for Medium Volume Sales, an estimated 63 customers in the medium volume classification, each with Class 2 or larger meters, had at least one month where the calculated increase is over 100 percent; during these months of 100 percent increase, the average monthly usage was less than 300 therms for all 63 customers. Further review of the projected annual increase for customers with a greater-than 100-percent increase in any month found the largest annual increase to be six percent for one customer¹⁶³.

For Medium Volume Transportation customers the Company estimated that three customers in the medium volume classification, all with Class 4 meters, had at least one month where the calculated increase is over 100 percent; during these months of 100 percent increase, the average monthly usage was less than 300 therms for all three customers. Further review of the projected annual increase for the customers with a greater-than 100-percent increase in any month found each to have an annual reduction of three to eight percent¹⁶⁴.

4. Rate LV – Large Volume Service

Mr. Johnson's review of the Large Volume customers who were previously Rate 85 Sales and Transportation customers found that there were mostly decreases for customers using the therm levels identified¹⁶⁵.

5. Commission Conclusion

The Commission finds that the bill impact information prepared by MEC and discussed by MEC and Staff lend support to the rates that the Commission is approving in this proceeding. The bill impact studies were adequate and sufficient for this purpose.

D. TARIFF REVISIONS

Mr. Johnson pointed out that MEC's "Availability" and "Reassignment of Rate" sections on Rate RV, Rate SV, Rate MV, and Rate LV tariffs state that service to

¹⁶² Staff Ex. 7.0 at 35.

¹⁶³ Staff Ex. 7.0 at 36.

¹⁶⁴ *Id.*

¹⁶⁵ Staff Ex. 7.0 at 36.

customers should be based upon “Peak Daily Usage.”¹⁶⁶ Staff stated that the Company’s proposal could create a situation where customers are penalized for going one therm over their defined availability therm level. A customer may go over the maximum prescribed therm level on only one day and it may only be for one therm, but they are then penalized by being assigned to a rate class that has higher rates for 12 months. Staff recommended that the Commission Order MEC to use average daily usage as the criterion for “Availability” and “Reassignment of Rate” on the rate tariffs instead of Peak Daily Usage¹⁶⁷.

MEC stated that its preference is to use Peak for establishing rate availability, but would not oppose revising the rate availability based on the average daily usage¹⁶⁸. MEC provided language in its rebuttal testimony that reflected the intent of Staff’s proposal¹⁶⁹.

Mr. Johnson accepted MEC’s proposed average daily usage language¹⁷⁰.

The Commission finds that it is reasonable to use average daily usage as the criterion for “Availability” and “Reassignment of Rate” in the rate tariffs instead of Peak Daily Usage.

E. MISCELLANEOUS TARIFF ISSUES

1. Rider S, elimination of Rates 80 & 87, and continuation of reporting class information

MEC proposed a new Rider S - System Gas Service tariff that is applicable to residential and non-residential customers who purchase company supply gas¹⁷¹. MEC also proposed to eliminate Rate 80 Contract Service and Rate 87 Off-Peak General Service. MEC witness Debra Kutsunis stated that there are no longer customers taking service under Rate 80 Contract Service and there are only three customers taking service under Rate 87 Off-Peak General Service. The Company contends that current Rate 87 customers will not be adversely affected by transferring to other non-residential rates¹⁷².

Mr. Johnson stated that he did not object to Rider S and the elimination of Rate 80 and Rate 87. In response to a data request, Staff found that, out of the three Rate 87 customers, one customer under the proposed Rate SV would see an annual increase of 1.77% and the other Rate SV customer would see an annual increase of

¹⁶⁶ Staff Ex. 7.0 at 39.

¹⁶⁷ *Id.* at 39-40.

¹⁶⁸ MEC Ex. MAA 2.0 at 7.

¹⁶⁹ MEC Ex. MAA 2.2 at 1 of 2 and 2 of 2.

¹⁷⁰ Staff Ex. 14.0 at 5-6.

¹⁷¹ MEC Ex. DLK 1.0 at 5.

¹⁷² *Id.* at 6.

1.00%. The Rate 87 customer that would be switched to Rate MV would see an annual increase of 2.86%¹⁷³.

MEC proposed to continue maintaining distinctions of residential, commercial, industrial, and public authority in its customer service information system for the purpose of reporting¹⁷⁴.

Mr. Johnson recommended that MEC continue to collect and keep the same type of data it currently maintains going forward for the residential, commercial, industrial, and public authority customers. He stated that the Annual Report that utilities provide to the Commission contains various sections that require customer designations by residential, commercial, *etc.* Commission Staff also periodically may need information that requires customer designation by the general classification of residential, commercial, and industrial. Additionally, the Commission is often interested in information related to residential customers although it has requested information for all other classes as well¹⁷⁵.

The Commission agrees with the introduction of Rider S - System Gas Service, the elimination of Rate 80 - Contract Service and Rate 87 - Off-Peak General Service. The Commission also agrees that MEC should continue to maintain distinctions of residential, commercial, industrial, and public authority in its customer service information system for the purpose of reporting.

2. Minor Tariff Language Changes

As part of its initial filing, MEC proposed a complete revision of its gas tariffs. Staff witness Mark Maple identified a number of MEC's revisions that were inconsistent with existing Commission rules and practices.¹⁷⁶ Mr. Maple proposed changes to the "Estimated Bill" section of Original Sheet No. 21, the "Billing Adjustments" section of Original Sheet Nos. 25-26, and the "Meter Tests" section of Original Sheet Nos. 26 & 62¹⁷⁷.

Ms. Kutsunis stated that the Company had agreed to Mr. Maple's proposed changes¹⁷⁸. Ms. Kutsunis also proposed some additional minor changes to several of the tariff sheets¹⁷⁹. Mr. Maple stated that he was not opposed to these additional, minor changes¹⁸⁰. Ms. Kutsunis provided revised tariff sheets that accurately reflect the final language to which the parties agree¹⁸¹.

¹⁷³ Staff Ex. 7.0 at 44 and 46.

¹⁷⁴ MEC Ex. MAA 1.0 at 18.

¹⁷⁵ Staff Ex. 7.0 at. 44-45.

¹⁷⁶ Staff Ex. 3.0 at 2.

¹⁷⁷ *Id.* at 3-7.

¹⁷⁸ MEC Ex. DLK 2.0 at 2-3.

¹⁷⁹ *Id.* at 3-6.

¹⁸⁰ Staff Ex. 10.0 at 2.

¹⁸¹ MEC Ex. DLK, Sched's. 2.1-2.6.

The Commission agrees with the changes proposed by Mr. Maple and Ms. Kutsunis, which are reflected on MEC Ex. DLK, Schedules 2.1-2.6.

XI. GAS TRANSPORTATION TARIFFS

A. UNCONTESTED ISSUES

MidAmerican proposed several changes to its gas transportation services as outlined in the testimony of Company witness Tom Gesell. The tariff changes included Maximum Hourly Quality Provisions (MHQ), Cashout Provisions, daily balancing charges and short critical day penalty rate¹⁸². The Company withdrew its changes to its daily balancing charges and agreed to leave the balancing provisions unchanged at this time¹⁸³.

Dr. David Rearden provided testimony on behalf of Staff and stated he believed that some of the provisions modifying the gas transportation tariffs were overly restrictive. The parties were able to resolve several of the issues outlined below.

1. Maximum Hourly Quantity Provisions

The Company proposed tariff provisions that would require all Large Volume sales service and gas transportation customers to elect a Maximum Hourly Quantity (MHQ) representing the maximum quantity of gas MidAmerican is obligated to deliver to the customer on a firm basis in a given hour on Short Critical Days¹⁸⁴. The Company proposed these provisions for two reasons. First, the size of pipe and facilities needed to serve a customer's facility is driven by hourly rather than daily consumption. A customer that uses 100 dekatherms (Dth) of natural gas all in one hour has a need for pipe and/or facilities that can handle larger volumes than the pipe and/or facilities needed for a customer whose 100 Dth of natural gas is spread throughout an entire gas day, averaging perhaps no more than 5 Dth/hour¹⁸⁵. Second, this requirement is necessary to properly manage the distribution system. The demand for natural gas has grown significantly, and many portions of the pipeline grid, including portions of the Natural Gas Pipeline Company ("NGPL") system, are operating at their design, or maximum, capacity¹⁸⁶. MEC explained the cost to increase capacity on either the interstate pipeline or on the utility's distribution system is expensive. Interstate pipelines serving MidAmerican's distribution system have both contractual daily and operational hourly limits by delivery point. Each pipeline serving MEC has, by tariff, the right to limit the amount of gas MEC can receive at a specific delivery point into its system.

MEC explained that the MHQ benefits Large Volume transportation customers able to limit hourly takes during critical hourly restriction periods, by lowering their

¹⁸² MEC Ex. TAG 1.0 at 3.

¹⁸³ MEC RB at 22-23.

¹⁸⁴ MEC Ex. TAG 1.0 at 4.

¹⁸⁵ *Id.* at 4.

¹⁸⁶ *Id.*

demand costs while still providing the ability to flow gas without restriction during non-critical periods¹⁸⁷. The process provides customers with the flexibility to plan and contract for the level of firm service they desire, taking into consideration the many factors unique to each customer. If a customer is faced with paying a large sum of money to expand upstream delivery capacity in order to maintain firm service, they may opt to either install backup supply facilities such as propane, or to restrict usage during the few Short Critical Days instead of paying for capacity upgrades. MidAmerican argued the MHQ process provides both the customer and the Company with the opportunity to plan for an economical service. Additionally, the provision provides an additional option for the customer to manage its distribution costs.

Staff agreed that there may be occasions where MidAmerican should be able to impose a Critical Hourly Restriction (CHR) on its system when a pipeline has not¹⁸⁸. Staff, however, indicated that the tariff should specify the conditions under which MidAmerican can issue a CHR. The Company and Staff were able to agree on the revised tariff provisions¹⁸⁹. Accordingly, the changes will be reflected in the Company's new tariff sheets consistent with the Commission's Ordering paragraph number 12.

2. Transport Storage

Staff recommended that MidAmerican offer storage service to transport customers. Staff noted that in the current arrangement, a customer switching from sales service to transportation service loses access to the storage resources available to the sales customer¹⁹⁰. Sales customers receive the benefits from storage services and pay for them in the PGA. That is, sales customers implicitly consume storage services by purchasing PGA gas¹⁹¹. Staff argued that if a customer were to switch to transportation service, that customer would no longer receive the storage services purchased by the utility for its customers¹⁹².

MidAmerican indicates that it does not have company-owned storage and that it is not aware that any transport customers would need MEC to broker storage from the pipelines on their behalf. Therefore, MidAmerican opposes a requirement to offer a service that is not based on any specific customer desire or requirement, especially given that interstate pipeline storage is available to transport customers themselves. MEC further asserts that a storage requirement would only add additional costs on top of the interstate pipeline storage service¹⁹³.

At hearing, there was significant discussion regarding the cost of implementing such services. Mr. Gesell provided an initial estimate of the cost at \$250,000¹⁹⁴. Dr.

¹⁸⁷ MEC Ex. TAG 1.0 at 5.

¹⁸⁸ Staff Ex. 11.0 at 4.

¹⁸⁹ MEC IB at 49.

¹⁹⁰ Staff Ex. 11.0 at 16; Staff IB at 37.

¹⁹¹ Tr. at 109.

¹⁹² *Id.*

¹⁹³ MEC IB at 49.

¹⁹⁴ MEC Ex. TAG 3.0 at 6; Tr. at 46-47 (Gesell).

Rearden acknowledged that the company would be permitted to recover the cost of implementing a new storage service¹⁹⁵.

As a compromise, the parties agreed that MidAmerican would invite customers to a meeting to discuss possible storage services, and Staff would also be a part of the discussions. MidAmerican would then report back to the Commission as to whether any transport customers were interested in such service. If transport customers were interested in storage services, MidAmerican would try to create storage services based on those needs. If the transport customers were not interested in storage services, MidAmerican would not create a tariff for storage services¹⁹⁶. If it is determined that transport customers are interested in the service, MidAmerican will also report to the Commission on the estimated costs to implement the service.

The Commission finds this approach reasonable and will not direct the Company to offer transport storage at this time.

B. CONTESTED ISSUE - CASH-OUT PROVISIONS

MEC proposes to change the cash-out provisions in its transportation tariffs. Cash-out is part of the process by which MEC assigns the commodity cost of matching delivered gas to consumed gas each day. On any given day, gas enters MEC's distribution system to serve both bundled service customers and gas transportation customers. Some of that gas enters the system at the direction of transportation customers. When the aggregate amount provided by those customers is less than the aggregate amount consumed by their end users, the transportation customers are "short" or "negative." In that case, MEC provides additional gas to meet the shortfall. Conversely, when the transportation customers deliver more gas into the system than their end users consume, the transportation customers are "long" or "positive." MEC then buys the excess gas delivered by the transportation customers. Cash-out is the daily calculation of gas sold to cover transportation customers' shortfall or gas bought when those customers are "long."

According to MEC, some transportation customers are exploiting arbitrage opportunities presented by the Company's current cash-out methodology. As MEC explains it, when those customers perceive that the price of acquiring gas from MEC is less than the price of other sources, they intentionally deliver short. Conversely, when the price MEC will pay for excess gas is higher than the transportation customers' cost of that gas (which apparently occurs much less frequently), transportation customers will deliver too much. As MEC sees it, its present cash-out structure tends to create an incentive for short deliveries in particular.

MEC currently uses the NGPL-Midcontinent index to determine the sell price for transportation customers that under-deliver gas¹⁹⁷. That price is typically lower than the

¹⁹⁵ Tr. at 122-123 (Rearden).

¹⁹⁶ *Id.* at 146-47.

¹⁹⁷ MEC Ex. TAG 1.0 at 9.

price at which transportation customers could otherwise obtain gas for delivery to the MEC system¹⁹⁸. Those customers cannot obtain the NGPL-Midcontinent price directly, because there is no available capacity at the NGPL-Midcontinent delivery point¹⁹⁹.

The adverse result of cash-out arbitrage by transportation customers, MEC asserts, is that bundled (or PGA or sales) customers are harmed by bearing additional gas costs through the PGA. That occurs because MEC does not actually obtain gas via NGPL-Midcontinent to cover the delivery shortfall transport customers cause, even though it uses the NGPL-Midcontinent index to determine the price it will charge those transport customers²⁰⁰. Rather, MEC resorts to other sources with available capacity and higher gas prices²⁰¹. Those higher prices flow through MEC's PGA, like all other gas prices incurred on any given day²⁰². Transport customers are required to reimburse the PGA for the cost of gas purchased to cover the shortfall, but they pay only the NGPL-Midcontinent index price, not the greater price actually paid to sources other than NGPL-Midcontinent to cover short deliveries. Thus, MEC concludes, sales customers are subsidizing transportation customers (in the amount of the differential between the NGPL-Midcontinent index price and the actual price of replacement gas). This subsidy totaled approximately \$8600 during the months of September-December 2008, according to an MEC analysis²⁰³.

MEC now seeks to alter its cash-out process by changing the price it charges under-delivering transportation customers for additional gas (as well as the price it pays transport customers that over-deliver gas). In addition to the NGPL-Midcontinent index price, MEC would also use two other indices associated with the NGPL pipeline system (Chicago City-gate and TexOk)²⁰⁴. MEC would charge transportation customers the highest daily price among the three indices to cover delivery shortfalls, and use the lowest daily price among the indices to buy excess delivered gas²⁰⁵. MEC believes that this revision will remove the incentive among transportation customers to deliver short and enjoy the benefit of NGPL-Midcontinent index pricing.

Staff opposes MEC's proposed cash-out revision. Staff argues that MEC is attempting to address a non-existent problem, as evidenced by the minimal amount of the purported subsidy (\$8600), which Staff characterizes as equivalent to a "rounding error."²⁰⁶ Moreover, Staff avers, even that trivial sum is inflated, because MEC focused on an abbreviated time period that produced the largest subsidy²⁰⁷. Further, Staff emphasizes, MEC does not include the impact of critical days in its analysis. If it had,

¹⁹⁸ *E.g.*, Tr. 61 (Gesell).

¹⁹⁹ *Id.* at 40.

²⁰⁰ MEC Ex. TAG 1.0 at 9.

²⁰¹ *Id.* & Tr. 53-54.

²⁰² MEC Ex. TAG 2.0 at 6.

²⁰³ MEC Ex. TAG 2.1, Sch. 2.

²⁰⁴ MEC transportation customers in Illinois can only bring gas on MEC's system via NGPL. Staff Ex. 11.0 at 5.

²⁰⁵ Staff Cross-Ex. 1.

²⁰⁶ Staff RB at 9.

²⁰⁷ Staff Ex. 11.0 at 11.

Staff calculates the differential at only \$3300²⁰⁸. Given that minimal sum, Staff maintains that it would not be reasonable to infer that transportation customers are “systematically gaming the system.”²⁰⁹ Accordingly, Staff concludes that sales customers are not harmed by the current cash-out methodology, rendering revision unnecessary.

Initially, the Commission notes that Staff places an inappropriate hurdle in the path of MEC’s proposed revision. Staff is incorrect that “MEC has the burden to prove that sales customers are not harmed by the current tariff.”²¹⁰ Pursuant to Section 9-201(c)²¹¹ of the Act, MEC is obliged to prove “the justness and reasonableness of [its] proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part.” That is not the same as proving customers are currently being harmed (although alleviating customer harm *can* be one of the attributes that makes a new tariff provision just and reasonable). Moreover, the Commission would not adopt a standard by which providers could only improve their tariffs, practices and rules if they first prove customer harm. Accordingly, MEC’s burden here is to show that its cash-out provision is just and reasonable.

With regard to the dollar-amount of the apparent subsidy furnished by sales customers, the Commission observes that the minimal sum involved (\$8600) does not favor the argument of either MEC or Staff. Because neither side has been willing to compromise its position, despite the relative insignificance of the relevant sum, the Commission assumes that each party believes there is a meaningful principle at stake. We therefore resolve this issue as a question of policy, irrespective of the amount quantified in MEC’s limited study.

MEC has demonstrated that its existing cash-out process creates arbitrage opportunities that some transportation customers have exploited²¹². It has shown that sales customers have, at times, shouldered financial responsibility for the consequences of that arbitrage. The company has also established that the adverse consequences of arbitrage will increase when MEC has to resort to increasingly costlier supply if a shortfall expands²¹³. MEC’s proposed high/low cash-out solution is rationally and proportionally aimed at curtailing the arbitrage, and associated subsidy, that the Company describes. Moreover, it creates incentive for transportation customers to accurately balance their daily supply and demand.

Staff cautions that MEC’s cash-out proposal will not reduce arbitrage and presents an example in support of that position. In Staff’s scenario, transportation customers over-deliver gas because they believe other customers will deliver short²¹⁴. If enough customers do this, Staff says, gas supply will be long for the day and the

²⁰⁸ Staff IB at 35.

²⁰⁹ *Id.*

²¹⁰ Staff RB at 9.

²¹¹ 220 ILC 5/9-201(c).

²¹² *E.g.*, Tr. 40-41 (Gesell).

²¹³ *Id.* at 53-54.

²¹⁴ Staff RB at 10-11.

transport customers will only receive the lowest price available through MEC's proposed high/low cash-out process. Conversely, if too many customers intentionally under-deliver, causing a short day, they will have to pay the highest price in the high/low index. But as the Commission sees it, that is precisely what should happen. Transportation customers should arrange delivery to meet their end-users needs, not to speculate on (attempt to arbitrage) the imbalances of other transportation customers. Staff's example actually shows that MEC's proposal will create an appropriate disincentive to such arbitrage.

The Company's proposed high/low cash-out provision is approved.

XII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having reviewed the entire record herein and being fully advised in the premises, is of the opinion and finds that:

- (1) MEC Energy Company is an Iowa corporation engaged in the storage, transmission, distribution and sale of natural gas at retail in Illinois and as such is a public utility within the meaning of the Public Utilities Act;
- (2) the Commission has jurisdiction over the parties and over the subject matter herein;
- (3) the findings and conclusions stated in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact; Appendix A attached hereto provides supporting calculations for various portions of this Order;
- (4) the test year for the determination of the rates found in this Order to be just and reasonable is the historical test year ending December 31, 2008 with pro forma adjustments; such test year is appropriate for purposes of this proceeding;
- (5) for purposes of this proceeding, MEC's net original cost of gas rate base is \$37,146,000;
- (6) MEC should be allowed an opportunity to earn a just and reasonable rate of return on its net original cost gas rate base of 7.60%; this rate of return incorporates a rate of return on common equity of 10.13%;
- (7) MEC's rates which are presently in effect for gas service are insufficient to generate the operating income necessary to permit MEC the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

- (8) the rates proposed by MEC for its gas operations will produce a rate of return in excess of a return that is fair and reasonable; MEC 's proposed gas rates should be permanently canceled and annulled;
- (9) MEC should be authorized to place into effect tariff sheets which will produce annual gas operating revenue of \$20,164,000, which represents an increase of \$2,741,000 or 14.86% in base rate tariff revenues; such revenue will provide MEC with an opportunity to earn the rate of return set forth in Paragraph (6) above based on the test year herein approved, with such tariff sheets to be applicable to service furnished on and after their effective date;
- (10) the interclass revenue allocation, rate design, and tariff terms and conditions discussed and accepted in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted;
- (11) the new tariff sheets authorized by this Order should be filed within five (5) business days and should reflect an effective date not less than four (4) business days after the date of the compliance filing, with the tariff sheets to be corrected within that time period if necessary;
- (12) It is further ordered that the \$117,982,708 original cost plant for MidAmerican at December 31, 2008, as reflected on the Company's Schedule B-4, Page 2 of 2, line 51, Column (e), subject to any adjustments ordered by the Commission in the course of this proceeding, is unconditionally approved as the original cost of plant for the purposes of 83 Ill. Adm. Code 510;
- (13) the Commission finds pursuant to Section 9-229 of the Act, that amounts expended by the utility to compensate attorneys and technical experts associated with the preparation and litigation of the instant proceeding appear just and reasonable, based on the testimony and record evidence;
- (14) all objections, petitions or motions in this proceeding, which remain undisposed of, should be disposed of in a manner consistent with the ultimate conclusions contained in this Order.

IT IS THEREFORE ORDERED that the tariffs presently in effect for gas service rendered by MidAmerican Energy Company are hereby permanently cancelled and annulled effective at such time as the new gas tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the Filed Rate Schedule Sheets proposing a general increase in gas rates, filed by MidAmerican Energy Company on June 2, 2009 are permanently canceled and annulled.

IT IS FURTHER ORDERED that MidAmerican Energy Company is authorized and directed to file new tariff sheets with supporting workpapers in accordance with Findings (9), (10), (11) and (12) of this Order, applicable to gas service furnished on and after the effective date of said gas tariff sheets.

IT IS FURTHER ORDERED that the \$117,982,708 original cost of plant for MidAmerican at December 31, 2008, as reflected on the Company's Schedule B-4, Page 2 of 2, line 51, Column(e), subject to any adjustments ordered by the Commission in the course of this proceeding, is unconditionally approved as the original cost of plant for the purposes of 83 Ill. Adm. Code 510.

IT IS FURTHER ORDERED that any objections, petitions, or motions in this proceeding that remain undisposed of are hereby disposed of consistent with the ultimate conclusions herein contained.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code Section 200.880, this Order is final; it is not subject to the Administrative Review Law.

DATED:
BRIEFS ON EXCEPTIONS:
REPLY BRIEFS ON EXCEPTIONS:

February 19, 2010
March 2, 2010
March 8, 2010

David Gilbert
Administrative Law Judge